SCS Agency
Franchise Tax Board

ANALYSIS OF ORIGINAL BILL

Author: McPherson	Analyst: Marion Mann DeJong	Bill Number: SB 276	
Related Bills: See Legislative History	Telephone: (916) 845-6979	Introduced Date: 02/06/97	
	Attorney: Doug Bramhall	Sponsor:	

SUBJECT: Manufacturers' Investment Credit/Eating Places

SUMMARY

This bill would create an investment credit for taxpayers in the lines of business described in the Standard Industrial Classification Code 5812 (eating places such as restaurants, caterers, fast food, coffee shops or dinner theaters). This credit is similar to the Manufacturers' Investment Credit (MIC).

EFFECTIVE DATE

This bill would apply to taxable or income years beginning on or after January 1, 1997.

LEGISLATIVE HISTORY

SB 671 (Stats. 1993, Ch. 881); SB 676 (Stats. 1994, Ch. 748); AB 1502 (1996); SB 38 (Stats. 1996, Ch 954.); AB 138 (1997) and SB 38 (1997).

SPECIFIC FINDINGS

Existing state and federal laws generally allow a depreciation deduction for the obsolescence or wear and tear of property used in a business or investment property. The property must have a limited, useful life of more than one year and includes equipment, machinery, vehicles and buildings but excludes land. Property is assigned to specific classifications related to the number of years of its useful life. The property then may be depreciated over the number of years of its useful life (recovery period).

Existing state and federal laws allow a taxpayer to deduct expenses paid or incurred in the ordinary course of a taxpayer's business.

Existing state law allows taxpayers to use various credits against tax. The Manufacturers' Investment Credit (MIC) allows qualified taxpayers a credit equal to 6% of the amount paid or incurred after January 1, 1994, for qualified property that is placed in service in California.

For purposes of the MIC, a qualified taxpayer is any taxpayer engaged in

DEPARTMENTS THAT MAY BE AFFECTED:

____ STATE MANDATE ____ GOVERNOR'S APPOINTMENT

Department Director Position:	Agency Secretary Position:	GOVERNOR'S OFFICE USE
____ S ____ O ____ SA ____ OUA ____ N ____ NP ____ NA ____ NAR ________ PENDING	____ S ____ O ____ SA ____ OUA ____ N ____ NP ____ NA ____ NAR DEFER TO ____________	Position Approved ____ Position Disapproved ____ Position Noted ____
Department Director	Agency Secretary Date	By: Date:

manufacturing lines of business described in specified codes in the Standard Industrial Classification (SIC) Manual. Qualified property is any of the following:

1) Tangible personal property, used in specified SIC Code establishments, that is defined in Section 1245(a) of the Internal Revenue Code and used primarily:

- for manufacturing, processing, refining, fabricating or recycling of property;
- for research and development;
- for the maintenance, repair, measurement, or testing of otherwise qualified property; or
- for pollution control which meets or exceeds state or local standards.

2) The value of any capitalized labor costs directly allocable to the construction or modification of the qualified property.

3) For specified taxpayers, special purpose buildings and foundations.

Under both the Personal Income Tax (PIT) law and the Bank and Corporation Tax (B&CT) law, **this bill** would allow qualified taxpayers a credit equal to 6% of the amount paid or incurred for qualified property that is placed in service in California.

"Qualified taxpayers" are those engaged in lines of business described in Code 5812 of the SIC Manual published by the United States Office of Management and Budget, 1987 Edition. SIC Code 5812 describes establishments primarily engaged in the retail sale of prepared food and drinks for on-premise or immediate consumption. This code includes establishments such as caterers, coffee shops, dinner theaters, fast food restaurants, hamburger and hot dog stands, pizza parlors, restaurants, and soda fountains. For a more comprehensive list of the establishments included in this SIC Code, please see Attachment A.

Under this credit, "qualified property" is defined as:

1) Tangible personal property used in SIC Code 5812 that is defined in Section 1245(a) of the Internal Revenue Code and used primarily:

- for manufacturing, processing, refining, fabricating or recycling;
- for research and development;
- for the maintenance, repair, measurement, or testing of otherwise qualified property; or
- for pollution control which meets or exceeds state or local standards.

2) The value of any capitalized labor costs directly allocable to the construction or modification of the property listed above.

This bill also would include computer software which is used for the purposes expressed in #1 above as "qualified property."

This bill would explicitly exclude certain types of property from the definition of qualified property, including furniture, facilities used for warehousing purposes after completion of the manufacturing process, inventory, equipment used in the extraction process or to store finished products, and tangible personal property used in administration, general management, or marketing.

This credit provides a variety of special definitions, including "qualified cost," "manufacturing," "research and development" and "small business."

This bill would provide special rules for costs paid pursuant to a binding contract in existence on or after January 1, 1997. Special rules also are provided for leased property. The credit may be carried over until exhausted, for a maximum of eight years. For small businesses, this carryover is extended to ten years. The taxpayer must recapture any credit previously allowed if the property is removed from California, disposed of to an unrelated party or converted to an unauthorized use within one year from the date the property is first placed in service in California.

The credit enacted by **this bill** would be repealed on January 1, 2002, or on January 1 of the earliest year after 2002 if the total employment in this state does not exceed by 100,000 jobs the total employment in this state on January 1, 1994. The Employment Development Department (EDD) is required to report to the Legislature annually on this determination.

Policy Considerations

The provisions of this bill raise the following policy concerns.

- The employment test used to determine if the credit should be repealed is based on the number of jobs created between January 1, 1994, and January 1, 2002, a test designed for the original MIC. The author may wish to use this bill's operative date of January 1, 1997, as the starting date for this determination since any changes in the number of jobs in 1994, 1995 and 1996 cannot be attributed to this credit.

- Department staff understands that a new edition of the SIC manual will be published within the next year. The new edition of the SIC manual should be reviewed upon its publication and any necessary changes to the SIC manual references in this bill should be made at that time.

- Certain business-related tax credits (e.g., low-income housing credit and research credit) are limited to the tax attributable to the taxpayer's passive activities. These credits are known as passive activity credits. The purpose of this limitation is to prevent taxpayers from using a credit from a passive activity to offset tax attributable to other income. Since this credit is not included in the list of passive activity credits, taxpayers who generate this credit from a passive activity would be able to use the credit to offset tax attributable to non-passive income.

Implementation Considerations

This bill would raise the following implementation concerns. Department staff is available to assist the author with any necessary amendments.

- The activity tests under the definition of “qualified property,” such as manufacturing, processing or refining property, research and development and pollution control, do not seem to connect with the criteria applicable to taxpayers and the property involved in eating establishments. An activity test involving the preparation and service of food may be more appropriate. Until the activity test is clarified, this bill may not be implemented as the author intended.

- The department issued extensive regulations for the MIC to resolve, among other things, issues relating to capitalized labor costs and the definition of tangible personal property. To avoid an extensive regulatory process for this credit, amendments are needed to resolve such issues.

- This bill provides for the recapture of the credit if the property is removed from California, disposed of to an unrelated party or converted to an unauthorized use within one year from the date the property is first placed in service in California. It is unclear whether this means first placed in service “by the taxpayer” in California. If not, it is unclear whether previously owned-property acquired by the taxpayer would qualify for the credit.

- The treatment of delivery vehicles and other items should be clarified.

Technical Considerations

Amendments are provided to resolve the following technical concerns.

- Amendments 1, 5, 6, 8, 9 and 10 would correct subdivision references.

- Amendment 2 would change “1996” to “1997” to correspond to the 1997 operative date of the bill.

- Amendment 3 would remove “or partnership” since recent legislation defined “taxpayer” for purposes of the R&TC to include a partnership.

- Amendment 4 would remove an unnecessary reference to Division 2.

- Amendments 7 and 11 would remove unnecessary text. Current law already provides for the carryover of credit beyond the repeal date (Section 17039(c)(2) and (d) and Section 23036(e) and (f)).

FISCAL IMPACT

Departmental Costs

If this bill were amended to resolve the department’s implementation concerns, it would not significantly impact the department’s costs.

Tax Revenue Estimate

This proposal is estimated to impact PIT and B&CT revenues as shown in the following table.

Fiscal Year Cash Flow Taxable Years Beginning After December 31, 1996 Enactment Assumed After June 30, 1997 $ Millions				
	1997-8	1998-9	1999-00	2000-01
Personal Income Tax	(6)	(7)	(8)	(8)
Bank & Corporation Tax	(12)	(12)	(14)	(15)
Total	(18)	(19)	(22)	(23)

This analysis does not consider the possible changes in employment, personal income, or gross state product that could result from this measure.

Tax Revenue Discussion

The revenue impact for this bill would be determined by the number of individuals engaged in the operation of eating places, qualified purchases and the amount of credits applied against available tax liabilities.

Qualified costs were estimated by factoring national investment figures to California using the ratio of California employment in SIC Code 58 (Eating and Drinking Establishments). SIC Code 5812, the code specified in this bill, represents virtually all (99.9%) of the national investment in Section 1245 property for SIC Code 58. (The capital expenditure figure was adjusted by 5%, 10% and 15% to include the turnover rate of businesses in SIC 58 in the following years.) This step provides the basis for determining the level of qualified costs that taxpayers could use for credit claims per taxable/income year. This level of qualified costs projected for 1997 income/taxable year was around $630 million, for which roughly one-half of generated credits would reduce tax liabilities that year and the balance carried over.

POSITION

Neutral, if amended.

The staff’s position would be neutral if the bill were amended to resolve implementation concerns addressed in this analysis.

Marion Mann DeJong
(916) 845-6979
Doug Bramhall

FRANCHISE TAX BOARD'S
PROPOSED AMENDMENTS TO SB 276
As Introduced February 6, 1997

AMENDMENT 1

On page 2, modify line 15 as follows:

operative under paragraph (2) of subdivision ~~(i)~~ (j). In the

AMENDMENT 2

On page 2, modify line 31 as follows:

January 1, ~~1996~~ 1997, and is thus not a "qualified cost."

AMENDMENT 3

On page 3, modify line 35 as follows:

means any taxpayer ~~or partnership~~ engaged in those lines

AMENDMENT 4

On page 7, modify lines 19 and 20 as follows:

a sale under Part 1 (commencing with Section 6001) ~~of Division 2~~, the original cost to the successor lessor of the

AMENDMENT 5

On page 7, modify line 29 as follows:

paragraph (2) of subdivision ~~(i)~~ (j) , shall be taken into

AMENDMENT 6

On page 8, modify line 9 as follows:

subdivision ~~(g)~~ (h).

AMENDMENT 7

On page 9, strikeout lines 25 through 27, inclusive.

AMENDMENT 8

On page 10, modify line 15 as follows:

paragraph (2) of subdivision ~~(i)~~ (j). In the case of any

AMENDMENT 9

On page 15, modify line 13 as follows:

subdivision ~~(g)~~ (h).

AMENDMENT 10

On page 15, modify line 27 as follows:

paragraph (2) of subdivision ~~(i)~~ (j), shall be taken into

AMENDMENT 11

On page 17, strikeout lines 23 through 25, inclusive.

ATTACHMENT A

Standard Industrial Classification Code 5812
Establishments primarily engaged in the retail sale of prepared food and drinks for on-premise or immediate consumption. Caterers and industrial and institutional food service establishments are also included in this industry.

Automats (eating places)
Beaneries
Box lunch stands
Buffets (eating places)
Cafes, Cafeterias
Carry-out restaurants
Caterers
Coffee shops
Commissary restaurants
Concession stands, prepared foods (e.g., in airports and sports arenas)
Contract feeding
Dairy bars
Diners (eating places)
Dining rooms
Dinner theaters
Drive-in restaurants
Fast food restaurants
Food bars
Food service, institutional
Frozen custard stands
Grills (eating places)
Hamburger and hot dog (frankfurter) stands
Ice cream stands
Industrial feeding
Lunch bars, Lunch counters, Luncheonettes, and Lunchrooms
Oyster bars
Pizza parlors and Pizzerias
Refreshment stands
Restaurants
Restaurants, carry-out food
Restaurants, fast food
Sandwich bars or shops
Snack shops
Soda fountains
Soft drink stands
Submarine sandwich shops
Tea Rooms
Theaters, dinner

This SIC Code does not include restaurants and lunch counters operated by hotels, bars and restaurants owned by and operated for members of civic, social and fraternal associations, or mobile food or dairy wagons.